

INSTITUTIONAL FRAMEWORK

“All natural resources in the soil and the waters of the country are under the jurisdiction of the State and shall be used for the greatest benefit and welfare of the People.”

-Article 33, Indonesian Constitution

The Indonesian Parliament (Dewan Perwakilan Rakyat – DPR) passed the oil and gas bill into law on October 23, 2001. The new law replaced Oil and Gas Law No. 44/1960 and Law for Pertamina No. 8/1971. It reduces the government's power over the petroleum sector and allows for open competition in the downstream oil and gas distributing and marketing area. The new law authorizes the establishment of an implementation agency ("badan pelaksana") and regulatory agency ("badan peraturan") to assume state oil and gas company Pertamina's roles. The implementation agency has replaced Pertamina in managing Production Sharing Contract (PSCs) with private oil and gas companies, thus eliminating the conflict-of-interest inherent when upstream producer Pertamina regulated the activity of its competitors. The law also removed Pertamina's monopoly in the downstream sector with the regulatory agency assuming the responsibility for managing natural gas and domestic fuel distribution and supply.

The GOI generally met the law's stipulation that the two new agencies be established within one year of the law's enactment, and that Pertamina establish itself as a limited liability company ("persero") within two years (see below).

Pertamina will maintain its overall responsibility for domestic fuel supply and distribution until December 31, 2006. Existing PSC's will be grandfathered and in effect until expiration of the contract. By the end of 2003, the GOI had issued three of five required implementing regulations under the law covering Pertamina's transition to a limited liability company, and the establishment of the implementing and regulatory agencies. By October 2004, the government issued the remaining two implementing regulations, on the upstream and downstream sectors.

All energy activities dealing with petroleum and gas fall under the Ministry of Energy and Mineral Resources, which is charged with creating and implementing Indonesia's energy policy. The Ministry of Energy and Mineral Resources is divided into several directorates, with the Directorate General of Oil and Gas (MIGAS) responsible for all aspects of petroleum industry development, including employee training and promulgating regulations.

BP Migas

On July 16, 2002, President Megawati signed Government Regulation No 42/2002, establishing an implementing body for oil and gas upstream operations, Badan Pelaksana Minyak dan Gas Bumi (BP Migas), as required by Oil and Gas Law No 22/2001. This upstream implementing body has taken over Pertamina's regulatory functions and responsibilities in managing oil and gas contractors.

BP Migas has managed upstream regulatory activities since mid-2002.

However it lacked implementing regulations until 2004 when the GOI issued Regulation 35 under the Oil and Gas Law 22/2001.

BP Migas' main responsibilities are to: 1) provide recommendations to the Minister in preparing and offering work areas and cooperation contracts; 2) sign cooperation contracts; 3) control upstream business operations and 4) appoint sellers of the government's share of oil and gas. BP Migas is a non-profit state legal entity and acts on behalf of the government as party to the cooperation contract with business entities. At the same time it also controls all oil and gas business operations.

BP Migas is led by a chairman and vice chairman, assisted by five expert staff and four main operational divisions—planning, operations, finance and marketing, and general affairs. The chairman is appointed by the President, based on the recommendation of the Minister of Energy and Mineral Resources after approval by the House of Representatives (DPR). The Chairman must periodically report to the President (every six months or as requested), via the Minister of Energy and Mineral Resources. The agency must also report and gives copies of signed Production Sharing Contracts to the DPR.

BPHMigas

On December 30, 2002 President Megawati Sukarnoputri signed Government Regulation (PP) 67/2002 establishing a new downstream regulatory body, the Badan Pengatur Hilir Minyak dan Gas Bumi (BPH Migas), which assumed the role of Pertamina in controlling downstream activities. BPH Migas was given the responsibility to regulate, develop and supervise the downstream industry. However BPH Migas lacked implementing regulations until 2004 when the GOI issued Regulation 36 for

the downstream activities laid out in Oil and Gas Law 22/2001.

BPH Migas' broad responsibilities are to: 1) regulate and determine the supply and distribution of oil-based fuel, 2) regulate the transmission and distribution of natural gas, 3) allocate fuel to meet national fuel oil reserve goals, 4) plan the use of oil and gas transportation and storage facilities, 5) set gas pipeline tariffs, 6) set natural gas prices for household and small consumers, 7) recommend pipeline levies, and 8) set the price of pipeline rights.

BPH Migas has the regulatory and development responsibilities to: 1) issue business licenses, 2) determine fuel types and standards for retail sale, 3) formulate strategic reserves policies, 4) determine price formulas for subsidized fuel, 4) protect occupational health and safety, 5) ensure environmental protection, and 6) promote community development. The agency is also charged with developing the master plan for national gas transmission and distribution. It also ensures the availability and distribution of fuel oil, and monitors reserves, market share and trading volumes.

BPH Migas is a smaller body than its upstream counterpart, BP Migas. BPH Migas consists of a committee of nine (one Chairman and eight members). Committee members are appointed by the President, based on the recommendation of the Minister of Energy and Mineral Resources after approval by the House of Representatives (DPR). The Chairman must periodically report to the President (every six months or as requested), via the Minister of Energy and Mineral Resources.

Pertamina

On June 18, 2003, President Megawati Sukarnoputri signed government regulation (PP) No. 31/2003 to transform the state oil and gas company Pertamina into a limited liability company (Persero). The objective of the new regulation was to establish a competitive and efficient entity, thereby increasing economic activity and the welfare of the people.

Under the new regulation, all state assets belonging to Pertamina are to serve as the capital of the new entity. The Minister of Finance based on a joint evaluation by the Minister of Energy and Mineral Resources and the Minister of Finance determined the amount of capital allocated to the new entity. The restructured Pertamina has authority from the government to supply fuel oils for domestic consumption, with compensation to be provided by the government. The regulation also gave Pertamina all the state's geothermal power assets with the proviso that they be handed over within two years to a new subsidiary. Pertamina said it plans to form a new subsidiary this year, PT Geothermal Energy, to manage those assets.

Pertamina significantly contributes to Indonesia's petroleum output. It ranks 6th in crude oil production and was Indonesia's 3rd largest producer of natural gas in 2004. Pertamina executives have expressed their determination to enhance Pertamina's position in the newly deregulated upstream sector.

In the down stream sector, Pertamina will maintain its monopoly on the distribution of subsidized fuel products throughout the archipelago until December 31, 2006. President Susilo Bambang Yudhoyono delayed full downstream fuel market deregulation by issuing Regulation 71/2005 on November 16, 2005 which extended Pertamina's public service

obligation (PSO) due to the lack of interest by other qualified companies.

In 2004, Pertamina suspended its operation in Block 3, Western Desert, Iraq due to political uncertainty. The company however, says that it wishes to resume exploration activity there as soon as the contract is ratified and the environment is permissive. Pertamina also ventured into Libya, where it won two exploration contracts in October 2005 for Block 17-3 on the Mediterranean Sea and Block 123-3 on the Sahara desert. Pertamina said it targeted Libya for investment to increase its resource base and to develop professionalism and credibility in the global oil business. The company reported provisional earnings of Rp 11.3 trillion (\$120 million) in 2005, almost double its annual target. The company said its upstream subsidiary, Pertamina E&P plans to invest up to \$100 million and drill 120 wells in 2006 to boost its oil and gas production.

Government Agreements and Contracts

Indonesia has two categories of agreements and contracts for its petroleum industry. The first category refers to the bundle of rights and obligations granted to an investor to invest in cooperation with the GOI in oil and gas exploration and exploitation. These types of contracts are the Production Sharing Contract (PSC), the Technical Assistance Contract (TAC), and the Enhanced Oil Recovery (EOR) contract, defined as follows:

Production Sharing Contracts:

- A cooperation contract for oil and gas exploration between BP Migas

and a private investor (which includes foreign and domestic companies, as well as PT Pertamina);

- BP Migas is the supervisor or manager of the PSC;
- Investors are participating interest holders and Contractors;
- The government take is under a production sharing arrangement whereby the GOI and the Contractors take a split of the production measure in revenue based on PSC-agreed percentages;
- Operating costs are recovered from production through Contractor cost oil formulas as defined by the PSC;
- The Contractor has the right to take and separately dispose of its share of oil and gas;
- Title of the hydrocarbons passes to the Contractor at the export or delivery point.

- Variation of a cooperation contract, or PSC;
- Used for established producing fields with the intent of applying advanced technology to increase the recovery of hydrocarbons in the reservoirs;
- Pertamina is usually a participant, along with investors; collectively they are the Contractor;
- BP Migas is the supervisor and manager of the EOR;
- Operating costs are recovered from production and typically capped at a percentage. In some cases, the incremental oil lifted from an EOR operation may be shared on a production sharing basis;
- In many cases, the EOR may also include provisions concerning how the parties will conduct petroleum operations.

Technical Assistance Contracts:

- Variation of a cooperation contract, or PSC;
- Typically used for established producing areas and therefore usually covers exploitation only;
- BP Migas is the supervisor or manager of the TAC;
- Operating costs are recovered from production;
- The Contractor does not typically share in production;
- The TAC can cover both exploitation and exploration if it involves an area where the GOI has encouraged exploration;
- In accord with Oil and Gas Law 22/2001, existing TACs will not be extended.

In addition to contracts that give bundles of rights to explore and exploit, the participants in the PSC, TAC or EOR may also enter into separate agreements to discuss how they are going to conduct petroleum operations. These are known as Joint Operating Agreements (JOA) and Joint Operating Bodies (JOB), defined as follows:

Joint Operating Agreements:

- A separate agreement in addition to the cooperation contract;
- Governs the relations of the participating interest holders, defining their rights and obligations, and describing the procedures the Contractors will abide by;
- The JOA typically includes: 1) the scope of operations; 2) designation, rights and obligations of the

Enhanced Oil Recovery:

operator; 3) establishment of an Operating Committee; 4) production disposition; 5) relinquishment, withdrawal and assignment; 6) confidentiality; 7) force majeure; and 8) dispute resolution and choice of law.

Joint Operating Bodies:

- Typically part of the JOA;
- Governs the operations on behalf of the participating interest holders by establishing a non-legal entity, the JOB, to conduct petroleum operations;
- Representatives of the participating interest parties appoint representatives to the JOB;
- The JOB prepares an operating work program and budgets and carries out operations pursuant to the JOB agreement and the cooperation contract;
- Participating interest holders remain the Contractors;
- JOAs are supervised by BP Migas.

Fiscal Decentralization Law

With implementation of a new fiscal decentralization law in January 2001, revenue-sharing formulas came into effect that directed 15 percent of the Indonesian Government's net oil revenues and 30 percent of its net natural gas revenues to provincial and district governments. The GOI's net oil and gas revenues refer to profit after cost recovery and deduction of the PSC share. Of the 15 percent of the oil revenue flowing to the regions, 6 percentage points will go to the regency of origin (where the PSC is located), 6 percentage

points will be shared among the other regencies in the province, and 3 percentage points will go to the provincial government. The same relative shares apply to gas revenues – 12 percent to the regency of origin, 12 percent among the remaining regencies and 6 percent to the provincial government.

OPEC

Indonesia joined OPEC in 1962 as active member and hosted important OPEC conferences in 1964, 1976, 1980 and 1997. OPEC member countries meet at least twice a year to coordinate their production policies in light of market fundamental. Organization of Petroleum Exporting Countries (OPEC) produce about 38 percent of the world's oil and 50 percent of the oil traded internationally. During 2004, Indonesian Minister of Energy and Mineral Resources Purnomo Yusgiantoro held the rotating OPEC presidency.

In an effort to control oil price volatility and anticipate strengthening crude prices, the Extraordinary Consultative Meeting of the Conference of the OPEC Oil Ministers in June 2005 agreed to raise production by 500,000 barrels per day to 28 million barrels per day, effective July 1, 2005. This was due to concern of possible shortages due to shortage of effective refining capacity and based on a forecast increase in oil demand in 2005. In addition, OPEC has also called upon non-OPEC members to join efforts in maintaining market stability. OPEC, through five increases, raised production quota by 4.5 million b/d from 23.5 million b/d to 28.0 million b/d since April 2004. Indonesia received a 233,000 b/d quota

increase to 1.451 million b/d, although actual output is closer to 1 million b/d.

OPEC quota
(in million b/d)

Members	Apr-04	Jul-04	Agust-04	Nop-04	Mar-05	Jul-05
Algeria	750	814	830	862	878	894
Indonesia	1.218	1.322	1.347	1.399	1.425	1.451
Iran	3.450	3.744	3.817	3.964	4.037	4.110
Iraq	-	-	-	-	-	-
Kuwait	1.886	2.046	2.087	2.167	2.207	2.247
Libya	1.258	1.365	1.392	1.446	1.473	1.500
Nigeria	1.936	2.101	2.142	2.224	2.265	2.306
Qatar	609	661	674	700	713	726
S.Arabia	7.638	8.288	8.450	8.775	8.937	9.099
UAE	2.051	2.225	2.269	2.356	2.400	2.444
Venezuela	2.704	2.934	2.992	3.107	3.165	3.223
Total	23.500	25.500	26.000	27.000	27.500	28.000

Source: OPEC

The Ministry of Energy and Mineral Resources has stated that Indonesia intends to remain an OPEC member despite its falling net oil export volumes. As Indonesia finds it increasingly difficult to maintain a net exporter status, industry observers will likely continue to question whether the country should keep its OPEC membership.

Other Professional Bodies

IPA

Indonesian and foreign oil companies operating in Indonesia established the Indonesian Petroleum Association (IPA) in 1971 in response to growing foreign interest in the Indonesian oil sector. Contractors and the government meet frequently to discuss matters such as production ventures and energy economics. The IPA's objective is to use public information to promote the exploration, production, refining and marketing aspects of Indonesia's petroleum industry.

IGA

Pertamina and key gas producers Mobil and Huffco sponsored the establishment of the Indonesian Gas Association (IGA) in 1980. The main objective of IGA is to provide a forum to discuss matters relating to natural gas and to advance knowledge, research and development in the areas of gas technology. IGA also aims to promote the development of infrastructure and cooperation among producing, transporting, consuming and regulatory segments of the gas industry.

The IGA and the IPA sponsored Indonesia's membership in the Permanent Council of the World Petroleum Congress (WPC).